McCarthy Asset Management, Inc.
Personalized Wealth Management

November 2012 Monthly Commentary

December 3, 2012

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Stock Market & Portfolio Performance

Stock Market Performance for November & YTD: The stock market rose modestly this past month while YTD returns are very good:

	Month Nov	YTD Nov	Comment:
Without Dividends:			
S&P 500	0.3%	12.6%	500 Largest Public U.S. Companies
NASDAQ	1.1%	15.5%	stocks trading on the Nasdaq
Russell 2000	0.4%	10.9%	2000 of the smallest U.S. stocks
MSCI EAFE	2.2%.	10.1%	international stock index
U.S. Aggr Bond	0.2%	4.4%	bond index
With Dividends, after all fees:			
Vang Index 500	0.6%	14.8%	Vanguard Index of S & P 500
MAM portfolios	0.9%	10.1%	non-very conservative MAM portfolios
MAM Conserv	0.4%	8.6%	very conservative MAM portfolios

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- **Investment Management**
- **Financial Planning**
- **Tax Advisory**

Fiscal Cliff– Status of It and How Serious Is It?

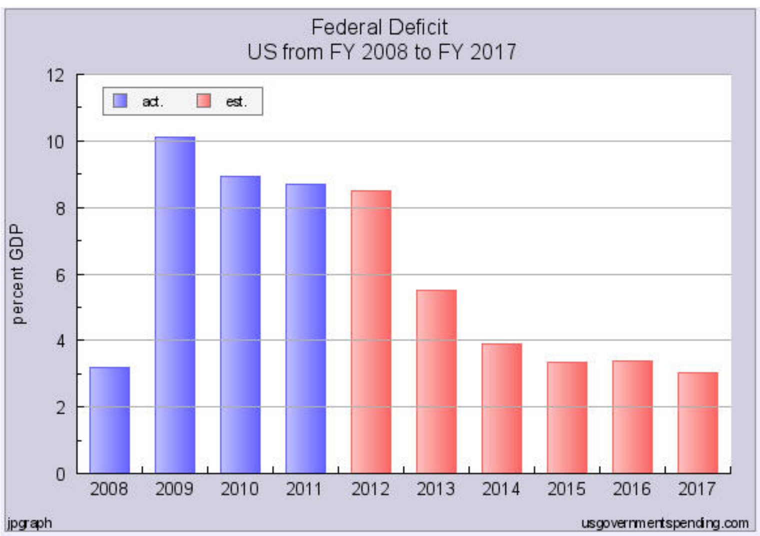
There was little progress made in November to avoid the 12/31/12 "Fiscal Cliff" when the Bush tax cuts expire and substantial cuts in Federal government spending start taking effect.

- What is known is that President Obama was reelected, the Democrats increased their control of the Senate while the Republicans retained control of the House of Representatives.
- What this means is that for the fiscal cliff to be avoided (or delayed) Democrats and Republicans are going to have to work together to reach an agreement.
- While the two sides have started talking to each other, there are still substantial differences with Democrats wanting to increase taxes on the "wealthy" and Republicans wanting entitlement reform (primarily Medicare and Social Security) .

What happens if no agreement is reached and the fiscal cliff takes effect? How dire would things become?

Possible Economic Impact: The non-partisan Congressional Budget Office (CBO) states that absent any action from Washington to avert the fiscal cliff, the U.S. economy will dip into recession with real (inflation-adjusted) GDP growth dropping to –0.5% on a Q4 2013 versus Q4 2012 basis, and the unemployment rate rising to 9.1%. This may sound ominous until one looks at the longer-term CBO projections. The agency predicts that the economy would bounce back quickly and sharply from the short-lived recession with real U.S. GDP growth averaging 4.3% from 2014-2017 and the unemployment rate falling to 5.7% by the end of 2017. While I am not sure how much credence can be put into these economic projections, they do indicate that short-term economic pain could soon transition into solid economic growth.

Federal Deficit– Declining in Percentage Terms: Overall, the Federal deficit remains elevated in dollar terms and as a percentage of gross domestic product. For fiscal 2012 (i.e. year ending 9/30/12), the actual deficit was $1.089 trillion, or about 7% of GDP (which is lower than what is shown on the chart to the right which reflects what was projected to be a 2012 deficit in excess of 8%). That is down from a peak of $1.413 trillion or 10.1% of GDP in 2009, but way above $162 billion and 1.2% in 2007.



How much further the deficit falls, and how quickly depends on what happens with the fiscal cliff. The CBO forecasts the cliff would shrink the annual deficit to $641 billion in 2013, or 4% of GDP. Under an alternative scenario in which many tax increases and spending cuts are postponed, the CBO forecasts the deficit would be $1.037 trillion or 6.5% of GDP for 2013.

That highlights lawmakers' dilemma: Going off the cliff will produce great pain in 2013 but lead to a more stable fiscal situation a decade on. Averting it will forestall a recession now but hamstring growth later. Charting a middle course, in which the deficit falls next year but not so fast that it cripples the economy is easier said than done (particularly because it requires politicians from both parties to work together).

How About Genuine Tax Overhaul? Our leaders have an opportunity now to make substantial changes to the tax code to make it simpler and more effective. The current code is complicated and it encourages tax avoidance, invites inefficient behavior, and gives incentives to special interests and parts of the economy that don't really need them any longer. Meanwhile it inadequately encourages spending and hiring that is beneficial in today's competitive global economy.

The broad outlines of what needs to be done are clear. Serious, long-term thinkers in both parties would agree that tax rates should be lower with fewer exemptions and loopholes. The corporate rate should be lower but more fairly enforced. The big question is whether American's political system is capable of taking on these kind of questions. As political scientist William Galston of the Brookings Institute observes, the two parties today are divided in power, but deeply divided ideologically. That makes common ground hard to find.

Roth IRA Conversions and "Back-Door" Contributions

If you expect to have very low or even negative taxable income for 2012, it may make a lot of sense to do a 2012 Roth IRA conversion. The deadline for 2012 conversions is December 31, 2012. Please contact me ASAP if you would like to discuss this further.

"**Back-Door" IRA Contributions:** While high-income taxpayers are allowed to convert IRA assets to a Roth IRA, they are not allowed to make regular Roth IRA contributions. A "back door" strategy that I have done for clients is to have them make a non-deductible IRA contribution (they are required to have earned income to make this contribution), and then to convert the contribution to their Roth IRA. This conversion can be done tax-free if they don't have any other IRA assets. This approach works well with a spouse who does not have other IRA assets.

Please contact me if you would like to discuss either a Roth IRA conversion or a "back door" Roth IRA contribution.

California Proposition 30 Passed– Retroactive Tax Increase

As a result of Proposition 30 being passed by California voters in November, California income tax rates have increased retroactive to January 1, 2012 for taxpayers with income of more than $250,000. California now has the dubious distinction of having the highest marginal tax rate among all fifty states (13.2% for income above $1 million; Hawaii is second highest with an 11% maximum marginal rate).

See the table to the right for the income levels affected by Prop 30.

Sales Tax Increase: Prop 30 also increased the sales tax rate by 0.25% for four years, beginning January 1, 2013, bringing the standard statewide rate to 7.5% (up from 7.25% currently). In addition to the statewide rate, some cities and counties have voter-approved district taxes.

Proposition 30 retroactively increases income taxes effective January 1, 2012. The following rate increases are effective for seven years:

Governor's Ballot Initiative	
10.3% (1% increase) on income of:	$250,001–$300,000 for single/MFS; $340,001–$408,000 for HOH; and $500,001–$600,000 for MFJ.
11.3% (2% increase) on income of:	$300,001–$500,000 for single/MFS; $408,001–$680,000 for HOH; and $600,001–$1,000,000 for MFJ.
12.3% (3% increase) on income of:	More than $500,000 for single/MFS; More than $680,000 for HOH; and More than $1,000,000 for MFJ.

(**Note:** Income in excess of $1 million is also subject to the 1% mental health surcharge.)

Portfolio Repositioning & Stock Market Outlook

I continue to have a mixed short-term outlook for the stock market. My main concern is the fiscal cliff and whether Congress and President Obama are able to find a way to mitigate the impact. I would be disappointed if all that is done is to "kick the can down the road" by simply delaying the tax increases and spending cuts. As discussed on the previous page, I feel the fiscal cliff provides an opportunity to revamp our tax code and make it simpler and more effective and provide greater motivation for companies to hire and invest.

We conducted the semi-annual repositioning of most portfolios in November. While no significant changes were made, we did add two funds to many portfolios, including the Schwab U.S. Dividend Equity ETF, which invests in high-quality dividend-paying stocks, has a strong track record over its short 1-year history, and has rock bottom annual operating expenses of 0.07%.

MAM portfolios continue to be relatively conservatively invested with most estimated to have 60% to 65% of the volatility of the S&P 500.

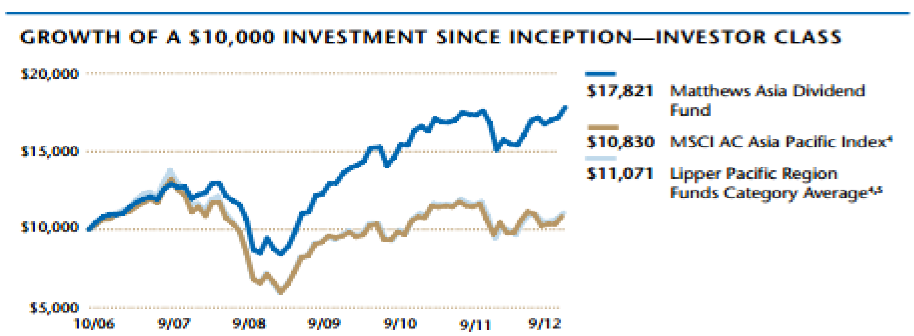
Profile on Matthews Asia Dividend Fund

Two and a-half years ago I attended a presentation from Robert Horrocks, Chief Investment Officer and Portfolio Manager with Matthew Funds, at the Northern California Financial Planning Association conference. San Francisco-based Matthews Funds is solely focused on investing in Asia. Bob presented a compelling case on the merits of investing in Asian companies. In particular, the dramatic growth in the middle class in Asian countries will enable them to experience among the highest growth rates in the world for at least the next ten to twenty years. Furthermore, given that nearly all Asian countries have trade surpluses, their currencies may provide a safe haven for U.S. investors. This was a factor in my decision to add a Matthew Asia fund to portfolios as my long-term outlook on the U.S. dollar is negative due to long-term fiscal challenges that our country faces.

I was particularly attracted to the Matthews Asia Dividend Fund ("the Fund") due to its tremendous record since its 2006 launch, and the fact that it focused on investing in stocks that pay a growing dividend complemented the dividend-stock theme that I was emphasizing in portfolios.

Here are some comments I have about investing in emerging markets in general and in the Fund in particular:

- Emerging markets have huge populations (China and India together account for half of the world's population). As their economies industrialize, large numbers of people are moving from rural areas to cities, opening up opportunities for them to get a better education and higher-paying jobs (and "move up to the middle class"). This leads to increased domestic consumption.
- Emerging-market stocks appear to be cheap. The MSCI Emerging Markets Index trades at less than 10 times estimated earnings for the coming year, compared with approximately 13 times for the S & P 500.
- Matthews Asia Dividend is a conservative, income focused approach to investing in Asian Emerging Markets. It is 60% as volatile as the MSCI EAFE index and offers a current yield of 2.5%.
- The Fund is anchored with relatively steady stocks. Consumer staple companies account for the largest portion of the portfolio at 21% (compared to the MSCI Asia Pacific Index which has a 7% weighing in consumer staple stocks). As such the Fund is positioned to benefit from increased consumer spending in Asian countries due to the rapid growth in the middle class and not so dependent on the growth of Asian exports to foreign markets.
- The performance of the Fund has been outstanding, as can be seen on the graph to the right.
- The annual operating expense ratio has dropped as assets in the Fund have increased and is now down to 1.1%, which is reasonable for an emerging market fund.



The performance data and graph do not reflect the deduction of taxes that a shareholder would pay on dividends, capital gain distributions or redemption of fund shares. Values are in US$.

- The bottom line is this is the type of fund that I seek for MAM portfolios: relatively low volatility, good yield, strong performance and invested in an area that has a very good long-term outlook.

Sincerely,

Stephen P McCarthy, CPA, CFP®

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Our Services

McCarthy Asset Management, Inc. (MAM) is an independent, privately owned Registered Investment Advisor firm. We provide clients with the peace of mind that comes from knowing professionals are managing their financial affairs. The services we offer include:

Investment Management Services:

- MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.

Financial Planning Services:

- The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.
- "Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.

Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:

- Tax Return Preparation
- Income Tax Projections
- Tax Minimization Ideas
- Tax Authority Representation

Other Services: MAM has retained several outside experts, whose services are available at no cost to our clients:

- Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.
- The Savvy Life® Classes and Workshops by best –selling author Melissa Tosetti

Reminders

1) Property Tax payments are due December 10, 2012.
2) Capital Gains: Consider realizing capital gains before the end of 2012 if you are likely to be impacted by the potential 2013 increases in capital gains rate.
3) 2012 Roth IRA Conversions: the deadline is December 31, 2012.

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